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REA BOOKKEEPING COURSE

Text No. 5

Completion of the Accounting Period

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UNITED STATES DEPARTMENT OF AGRICULTURE
Rural Electrification Administration
Finance Division
St. Louis 2, Missouri

COMPLETION OF THE ACCOUNTING PERIOD

Text No. 5

1. INTRODUCTION

The transfer or closing of all nominal elements indirectly to capital represents what is known as "closing the books". In order to understand this procedure, it should be kept in mind that the nominal accounts remain open for a definite period of time commonly referred to as the accounting period. They are in fact subordinate to the Capital account; inasmuch as they contain income and expense data for analytical and statistical purposes. Comparison of statistical information for different accounting periods is made primarily to ascertain variations and trends. It is therefore necessary to establish a fiscal or accounting period--such as a year, quarter-year, or month--and then to summarize income and expense, carrying the net result through Profit and Loss to the Capital account. The nominal accounts after being closed are ready to start over again to measure the profit and loss elements for the succeeding accounting period.

The fiscal period used by REA-financed electric systems corresponds to the calendar year. The nominal accounts are closed as of December 31, not to Profit and Loss, but directly to Earned Surplus (as was previously pointed out).

The process of closing the books results in a summary of the nominal or profit and loss accounts. Inasmuch as this summary is permanently recorded in the Profit and Loss Account, data essential to the preparation of a Profit and Loss Statement are available in that account; moreover, only real accounts remain open after the books have been closed, and these account balances can be arranged in balance sheet form. The process of closing the books causes the financial data contained in the ledger accounts to be put in such order as to facilitate preparation of the two major financial statements--the balance sheet and the profit and loss statement.

The primary reason for closing the books is to determine the financial results from operations for the accounting period and to determine the financial condition as of a given date. The balances of all nominal accounts then are closed and the accounts are ruled. Obviously, if they were allowed to remain open indefinitely their usefulness for statistical purposes would be defeated. For example, if the Sales account were allowed to remain open indefinitely it would accumulate a large credit balance that conveyed little useful information. On the other hand, if the same account is closed at regular intervals the total merchandise sales for each period stand out and furnish valuable data for comparison. The same argument may be used

with regard to other income and expense accounts. By successively opening and closing a system of nominal accounts, a clear view is presented of the economic history of each accounting period.

2. NECESSITY OF ADJUSTING THE ACCOUNTS

Before undertaking to close any set of books, the following questions must be considered:

(1) Are all completed transactions recorded to date of closing?
(2) Are there any expense elements mixed with those accounts which should be regarded primarily as expenses?
(3) Are there any asset values in those accounts which should be regarded primarily as expenses?
(4) Is there any element of liability in the accounts which have been established primarily to record income?
(5) Are there any expenses included with accrued liabilities unrecorded on the books, or,
(6) Are there any income items included with accrued assets that are likewise unrecorded?

If any of these questions can be answered in the affirmative, it means that the ledger accounts must be adjusted to reflect their true status. The adjusting process involves (a) giving recognition to all unrecorded data, and (b) separating mixed accounts into their real and nominal elements. This effects an equitable apportionment of income and expense to the respective fiscal periods and provides an accurate statement of assets and liabilities.

Unless facts that fail to appear on the books as the result of business transactions are brought into the accounts, conditions will be inaccurately reflected; unless mixed accounts are broken down, summarization of real and nominal elements will be difficult; and unless care is taken to include in the profit and loss summary over a given period all that properly applies to it, the presentation of financial data may be so distorted that the statements are of little value.

3. ADJUSTING THE TRIAL BALANCE

To illustrate how a pre-closing trial balance may be adjusted and the books of account closed at the end of an accounting period, assume that the books of Dan Ross are to be closed at January 31, 1944, for the purpose of determining profit and loss outcome and preparing a balance sheet. The trial balance given in Text 4 is again presented on the following page.

A trial balance such as this, containing a list of all open ledger accounts immediately following the last business transaction of the period and just before any adjustments have been made, is called a pre-closing trial balance. It contains all classes of accounts--real, nominal, and mixed. This is the starting point of adjusting and closing a set of books. After the trial balance has been taken, each item appearing therein should be verified for the purpose of determining necessary adjustments in order to reflect all facts accurately at the closing date.

Dan Ross
Trial Balance January 31, 1944

		Dr.	Cr.
Cash	(Real)	$ 1,335	
John Doe	"	500	
Notes Receivable	"	600	
Inventory	(Mixed)	2,500	
Furniture and Fixtures	"	600	
Building	"	5,000	
Land	(Real)	1,500	
City Supplies Company	"		$ 25
Notes Payable	"		3,250
Mortgage Payable	"		1,000
Dan Ross, Capital	"		7,500
Purchases	(Mixed)	1,150	
Purchases Returns and Allowances	(Nominal)		50
Sales	"		1,750
Sales Returns and Allowances	"	50	
Freight and Cartage In	(Mixed)	10	
Discounts on Sales	(Nominal)	9	
Discounts on Purchases	"		6
Insurance	(Mixed)	120	
Advertising	(Nominal)	60	
Store Supplies	(Mixed)	25	
Salaries	(Nominal)	100	
General Expenses	"	22	
		$13,581	$13,581

4. UNRECORDED TRANSACTIONS

If all completed transactions are recorded promptly, as was done on the books of Dan Ross, there will be no unrecorded transactions at the end of the fiscal or accounting period. As a matter of practice, however, we have seen that expenses sometimes are not entered until paid or until the

bill is received from the creditor. Likewise, merchandise may be received in advance of the seller's invoice.

At the end of an accounting period, all expenses must be recorded whether or not bills have been forwarded by creditors; and all merchandise purchases must be entered even if invoices have not been received. The question immediately arises: If an invoice or statement is not available, from what source is the data for entry procured? When goods are ordered, price quotations almost always are given; and a price for services usually is established in advance. It also is true that although the books are closed as of the end of a fiscal period, it may be several days or more after this time before the actual adjusting, closing, and preparation of statements are completed. Meanwhile invoices or bills applying to the period under review may be received and entered as of the closing date.

The dates on which expenses are incurred are the effective dates of transactions and not necessarily the dates on which payments are made. Likewise, income should be recorded when the right to it becomes effective; although payment is important, it is incidental to the element of gain or loss.

5. INVENTORY AND PURCHASE ADJUSTMENTS

The Inventory and Purchase accounts always require adjustment and are, therefore, the first items to which attention is directed. In recording merchandise purchases, the cost of freight and cartage inward was debited to a separate account, and returns and allowances were credited to a separate account. It was explained that these items could have been entered directly to Purchases but that for purposes of analysis it was desirable to have the data segregated. At the end of an accounting period this purpose has been accomplished and the accounts are brought together by transfer entries so that the Purchases account will reflect the cost of net purchases:

January 31, 1944 (Journal - Page 4)

			Dr.	Cr.
	Purchases	13	10 00	
	Freight and Cartage In	17		10 00
	To record charges applicable to total cost of merchandise.			
	- 31 -			
	Purchases Returns and Allowances	13	50 00	
	Purchases	13		50 00
	To reduce cost of goods by amount of returns and allowances.			

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The next step is the adjustment of the merchandise inventory. The opening inventory of merchandise and the purchases during the period are historical facts; but read together with Inventory and Purchase accounts, represent the cost of goods available for sale during the period. Here we have an example of asset values mixed with expense elements--the cost of goods sold during the period and the cost of merchandise now on hand. The Inventory and Purchases accounts are closely related. Initial inventory can be closed into the Purchases account at the beginning of the next fiscal or accounting period. However, this is usually not done until the close of the period. Since these balances represent data that are similar, the two accounts may be combined by the following transfer entry:

January, 1944 (Journal - Page 4)

			Dr.	Cr.
- 31 -				
	Purchases	13	2,500.00	
	Inventory (Opening)			2,500.00
	To transfer the inventory of January 1 and to arrive at total goods available for sale during the month.			

The purchase cost of merchandise now on hand is determined by listing the various articles and applying the proper value to each. In this case, closing inventory was valued at cost, $2,350, including applicable freight. In preparing a balance sheet, obviously this inventory would appear as an asset. Since this inventory is the real element now contained in the Purchases account, it must be removed if the Purchases account is to reflect the nominal element cost of goods sold. To accomplish this dual result, the following journal entry is made reducing the mixed account into its real and nominal elements:

January, 1944 (Journal - Page 4)

			Dr.	Cr.
- 31 -				
	Inventory (Closing)	4	2,350.00	
	Purchases			2,350.00
	To record merchandise inventory of January 31, and to reflect purchases a part of cost of goods sold.			

The effect of these entries upon the Purchases and Inventory accounts is shown by the following:

Purchases

1944				1944			
Jan. 31	Total purchases	$1,150	:	Jan. 31	Returns and Allowances	$ 50
31	Freight and Cartage	10	:	31	Closing Inventory	2,350
31	Initial Inventory	2,500	:			

Inventory

1944			:	1944		
Jan. 1	Merchandise on hand	$2,500	:	Jan. 31	To Purchases	$2,500
31	Merchandise on hand	2,350	:			

The balance of $1,260 in the Purchases account represents the cost of goods sold during the period and will be closed into Profit and Loss. The cost of goods sold is computed in the following manner:

Cost of Goods Sold:		
Merchandise Inventory January 1		$2,500
Add: Purchases	$1,150	
Less: Returns and Allowances	50	1,100
Freight and Cartage In		10
Goods Available for Sale		$3,610
Less: Merchandise Inventory Jan. 31		2,350
Total Cost of Goods Sold		$1,260

This is the method by which cost of goods sold is usually analyzed for statement purposes, and it will be further illustrated in Text No. 6.

The "cost of goods sold" procedure is basic in closing the books of most types of businesses. Electric utilities, such as REA cooperatives, may eliminate some of the steps involved. If they purchase the electric energy sold by them, there is usually a direct charge for it which constitutes the cost of goods sold and requires no further computation. If the utility generates the power it sells, the various costs involved must be summarized and totaled to provide the figure known as "cost of goods sold".

6. DEPRECIATION ADJUSTMENT

Depreciation is defined as an expense due to the decrease in value of property used in business operations. This decrease in value may be due to physical wear and tear, action of the elements, or economic causes such as obsolescence or inadequacy.

At one time it was contended that depreciation was not a constant and unavoidable business expense. Passage of the Federal Revenue Acts allowing

a deduction for depreciation charges strengthened the position of those who held that depreciation was an ordinary expense of business operations. This is the majority opinion today. The question then is, how should depreciation be recorded? We have a choice of two methods. One method would be to debit the Depreciation Expense account and credit the asset account. The language shows exactly what has occurred. Many accountants, however, object to this method on the ground that it tends to obscure the original cost of the property. To overcome this objection, accountants debit the Depreciation Expense account and credit Reserve for Depreciation which is an offset to the asset account.

Inasmuch as the assets, Furniture and Fixtures and Building, owned by Dan Ross are subject to depreciation, an adjustment is necessary to reduce the values shown on the trial balance and to record the expense incident to the loss in value because of use. Estimating depreciation on furniture and fixtures to be $5 and on the building to be $15 for the month, the following entries are made:

January, 1944 (Journal - Page 4)

				Dr.	Cr.
		-31-			
		Depreciation	25	5.00	
		Reserve for Depreciation of Furniture and Fixtures	5		5.00
		To record estimated depreciation of furniture & fixtures for the month of January, 1944.			
		-31-			
		Depreciation	25	15.00	
		Reserve for Depreciation of Building	6		15.00
		To record estimated depreciation of building for the month of January, 1944			

Here we use two accounts to record the data relative to a particular asset: The asset account proper, showing the original cost of the property and any subsequent additions thereto or any retirements; and the reserve for depreciation, which accumulates the credits for decreases in value due to depreciation. The asset account and its related reserve will appear on the books as follows:

Building

1944			
Jan. 1	Investment	$5,000	

Reserve for Depreciation of Building	
	1944
	Jan. 31 Depreciation for month $15

The two accounts are thought of and read as one account. Reserves for depreciation and accounts of similar nature are called valuation accounts because they have the effect of reducing the book value of the accounts to which they are related. They also are called offset accounts, or, accounts that are part of another account.

The reserve for depreciation is referred to by some as an "Allowance for Depreciation" because the term "reserve" has a different meaning in corporation accounting. However, the term "reserve" seems to be in common usage and we shall adhere to it in these texts. The important thing to remember is that any account called a Reserve for Depreciation or an Allowance for Depreciation is one established for the purpose of valuing the related asset and is in one sense part of the asset account. A reserve for depreciation should not be regarded as a liability merely because it has a credit balance, but always should appear upon the balance sheet as a deduction from the asset item to which it refers, thus:

Furniture and Fixtures	$600	
Less: Reserve for Depreciation	5	$595

The nominal account Depreciation will be closed into Profit and Loss along with other expense accounts.

7. ADJUSTMENT FOR UNCOLLECTIBLE ACCOUNTS

Experience teaches that, regardless of how cautiously we grant credit, a number of customers' charge accounts ultimately will prove to be uncollectible. Some debtors, because of adverse financial condition or dishonesty will not pay what they owe. Losses from this source are more or less inevitable.

There are two methods of dealing with bad debt losses. According to one method the loss is recorded on the books when the account is actually determined to be worthless; that is, bad debts are charged to expense as they arise. The journal entry to reflect this adjustment would be:

	Dr.	Cr.
Bad Debts	xxxx	
Customer's account		xxxx

Needless to say, no uncollectible items should be included in the Accounts Receivable or Notes Receivable on the balance sheet. Worthless accounts not previously written off should be cleared at the end of the accounting period. In the case of Dan Ross, it is assumed that both the open account of John Doe and the note of Frank Brown will be collected in full. Therefore, no adjustment for bad debt loss is required.

The second method of adjustment under which a valuation account entitled "Reserve for Bad Debts" is created for anticipated losses will be fully discussed in a subsequent text.

8. ASSET VALUES IN EXPENSE ACCOUNTS

Suppose that we charge an expense account for a prepaid service but that all the service paid for is not received during the period in which payment is made; or, suppose that we charge an expense account for supplies bought but that all the supplies are not used during the period: At the closing date there will be a remaining asset value commonly called a prepaid expense. Expense accounts of this type are mixed accounts containing a real element as well as a nominal element for services received or supplies used. Before statements are prepared, it is desirable to remove the real element and transfer it to another account, leaving the expense account entirely nominal. It is then possible to close out the nominal account balance to Profit and Loss and allow the real element to remain for balance sheet purposes.

In the trial balance of Dan Ross, we have two mixed accounts of this nature that are subject to adjustment--Store Supplies and Insurance. By actual count we find $10 worth of store supplies on hand; and it will be recalled that the $120 premium paid was for insurance covering the entire year. Inasmuch as only one month has elapsed, eleven-twelfths of the insurance premium applies to protection yet to be received. This is an asset value, and therefore the mixed account should be reduced into its real and nominal elements:

January 1944 (Journal - Page 4)

		Dr.	Cr.
-31-			
Prepaid Insurance	28	110 00	
Insurance	20		110 00
To set up unexpired insurance premium as of January 31, 1944			
-31-			
Store Supplies Inventory	29	10 00	
Store Supplies	22		10 00
To record the asset value supplies on hand at January 31, 1944.			

The mixed accounts are separated into two accounts, one of which is real and the other entirely nominal, reflecting the correct expense of the period:

Insurance (expense)	
$120	Jan. 31 $110

Store Supplies (expense)	
$25	Jan. 31 $10

Prepaid Insurance	
Jan. 31 $110	

Store Supplies Inventory	
Jan. 31 $10	

Accounts such as Prepaid Insurance, Supplies Inventory, etc. are technically known as deferred charges to expense or simply as prepaid expenses. Inasmuch as they will be consumed in the operations of future periods, as a rule, they are shown under a separate caption on the asset side of the balance sheet.

9. LIABILITIES IN INCOME ACCOUNTS

Cash may be received in advance for services to be rendered over a period of time. As soon as the payment is received, the business is under obligation to perform a service to an outsider. In such an instance the Cash account is usually debited and an income account credited for the reason that the credit, although originally a liability, will ultimately change to income with the lapse of time. At the end of the accounting period, if all of the services paid in advance have not been rendered, there will be a liability element in an account set up primarily to record income. An adjustment is then necessary to separate the mixed account into its real and nominal values.

There is no example of this type in the trial balance of Dan Ross at January 31; therefore no adjustment is required in his books.

For the purpose of this example, assume that a room in an office building is rented to an outsider on October 1 and at that time rent is received in advance for a period of six months. The transaction may be recorded as follows:

	Dr.	Cr.
Cash	xxx	
Rent Income		xxx

Then the books are closed on December 31 of the same year. Obviously, Rent Income has been credited for three months' rental that has not been earned during the current accounting period and for which no services have

yet been rendered. The account should be segregated into its real and nominal elements by the following adjusting entry:

	Dr.	Cr.
Rent Income	xxx	
Unearned Rent Income		xxx

This entry adjusts the nominal account to reflect the true income for the current period, and at the same time records rent collected in advance as a liability. This is regarded as a liability because the advance rental is unearned and may be returnable if the service contracted for is not rendered. As services are rendered the liability is decreased and the income is increased. The rent deferred is technically called a deferred credit to income or simply unearned income. Note that ordinarily a liability is discharged by the payment of money but that deferred credits are earned by the performance of services. For this reason deferred credits are, as a rule, shown under a distinct classification on the liability side of the balance sheet.

It frequently happens that services to outsiders are collected during the accounting period in which they are rendered. In this event, a debit to Cash and a credit to income will correctly reflect the transaction without adjusting the income from services rendered. In such cases the service period covered by the payment either falls within or coincides with the accounting period. However, this circumstance should not obscure the fact that it is the rendering of services and not the collection of cash that determines income earned. Services rendered increase capital whether or not cash is immediately collected. An account receivable may be established to record the asset value arising from the rendering of services. In the viewpoint of modern accounting theory, the collection of cash represents the realization of an asset receivable and does not affect the income account. Conversely, it is the receipt of services that determines expense rather than the payment of cash for services received or to be received in the future.

10. ADJUSTMENTS FOR ACCRUED LIABILITIES AND EXPENSES

Certain expenses and liabilities may accrue from day to day during an accounting period. Here we have an example of an expense combined with an accrued liability. In all probability there will be no record of this expense on the books until it is paid. However, if the accounts are to be closed before payment is due, this unrecorded expense and accrued liability must be entered in order that the correct operating results for the period can be determined and a correct balance sheet prepared.

The Mortgage Payable account in the ledger of Dan Ross indicates a credit balance of $1,000. Upon examination it is found that this mortgage

provides an interest charge of 6% per annum. The accrued interest to January 31 (1/12 year) would be $5. Since neither the expense nor the liability has been previously recorded, an adjusting entry reflecting this expense and accrued liability should be recorded as follows:

January 1944		(Journal - Page 4)	
31		Dr.	Cr.
Interest Expense	26	$5.00	
Accrued Interest Payable	27		$5.00
To record interest accrued for month of January, 1944, at 6% on mortgage payable of $1,000			

Other types of expenses may accrue in favor of creditors and require similar entries. A common example of this occurs when salaries are paid on a weekly basis and the last day of the accounting period does not fall on payday. There will be one or more days' salaries accrued in favor of employees and this expense and accrued liability should be recorded by an adjusting entry. This results in an accurate allocation of expense between present and future periods and records the liability which will become due at a future date.

11. ADJUSTMENTS FOR ACCRUED ASSETS AND INCOME

Adjustments for accrued assets combined with income result from a situation opposite to that in the case of accrued liabilities and expense. Services are being rendered under some form of contract for which no bill is issued. In all probability there would be no record of this income on the books until cash was collected; but if the books are to be closed before collection is made, the unrecorded income and accrued asset must be entered, if all facts are to be accurately indicated.

There is no example of an accrued asset combined with income in the transactions of Dan Ross. The note received from Frank Brown was non-interest bearing; therefore no adjustment is necessary.

If a note receivable is interest bearing and has not been collected at the date of closing the books, an adjusting entry is required to record the accrued interest and income earned. An accrued asset account is debited for the claim of the business against the individual from whom the income will be collected in a future period, and an income account is credited for the amount earned but not collected during the current accounting period:

	DR.	CR.
Accrued Interest Receivable	xx	
Interest Income		xxx

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Accrued receivables are current assets similar to accounts receivable or notes receivable. When the entire amount of interest is collected in a future period the entry would be:

	Dr.	Cr.
Cash	xxx	
Accrued Interest Receivable		xxx
Interest Income (of new period)		xxx

This method of handling accrued interest on a note receivable serves to illustrate how other accrued items of similar nature may be treated. In addition to interest there may be items such as royalties, commissions, rents, etc., which fall due at stated intervals and in connection with which income may be earned in one fiscal period but the cash is not collectible until some future period. Detailed discussions and illustrations of accruals, deferments, and bad-debt and depreciation adjustments will be given in texts that follow.

12. THE ADJUSTED TRIAL BALANCE

Many authorities treat the entries to transferring the balances of nominal accounts to the principal accounts as closing entries. For clarity we have included them among the adjustments. Purchases Returns and Allowances Account has been closed to Purchases so that the Purchases account would reflect the net amount. The following entry is made to reduce the sales account to a net figure:

January 1944 (Journal - Page 4)

		Dr.	Cr.
-31-			
Sales	14	50.00	
Sales Returns & Allowances	14		50.00
To reduce Sales to the net amount by transferring returns and allowances.			

Immediately after all the adjusting entries have been made and posted to the ledger accounts (see Section 14), another trial balance may be taken. This is known as an adjusted trial balance and proves that the books still are in balance. Since all unrecorded items have been reflected and the mixed accounts reduced into their real and nominal elements by the adjusting entries, the adjusted trial balance contains only real and nominal accounts as shown by the account balances. Because all amounts are now either assets, liability, and capital items (real), or income and expense items (Nominal), it is possible to prepare a balance sheet and profit and loss statement from the adjusted trial balance, as will be explained later.

Text No. 5

Dan Ross
Adjusted Trial Balance
January 31, 1944

		Dr.	Cr.
Cash	(real)	$ 1,335	
John Doe	"	500	
Notes Receivable	"	600	
Inventory (closing)	"	2,350	
Furniture and Fixtures	"	600	
Reserve for Depr. of Furn. & Fix.	"		$ 5
Building	"	5,000	
Reserve for Depr. of Building	"		15
Land	"	1,500	
City Supplies Company	"		25
Notes Payable	"		3,250
Mortgage Payable	"		1,000
Dan Ross, Capital	"		7,500
Purchases (cost of goods sold)	(nominal)	1,260	
Sales (net)	"		1,700
Discounts on Sales	"	9	
Discounts on Purchases	"		6
Insurance	"	10	
Advertising	"	60	
Store Supplies	"	15	
Salaries	"	100	
General Expenses	"	22	
Depreciation	"	20	
Interest Expense	"	5	
Accrued Interest Payable	(real)		5
Prepaid Insurance	"	110	
Store Supplies Inventory	"	10	
		$13,506	$13,506

13. CLOSING JOURNAL ENTRIES

Having all the income and expenses in the form of nominal account balances, we are ready to close these nominal accounts by journal entries transferring their balances to the Profit and Loss account. After all the nominal elements have been closed into the summary account, Profit and Loss, the balance of that account will be the net profit or net loss for the current fiscal period. This net profit or loss, as the case may be, will then be transferred to the proprietor's Capital account.

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As sales is the first item that has to be considered in preparing the profit and loss statement, it is desirable to close this account first. The following journal entry transfers the balance of the sales account to the Profit and Loss account:

January 31, 1944 (Journal - Page 5)

				Dr.		Cr.	
		Sales	14	1 700	00		
		Profit and Loss	30			1 700	00
		To close net sales of January 1944, into Profit and Loss summary.					

The Purchases account balance of $1,260 represents cost of goods sold. This balance logically is the next item to be closed into Profit and Loss.

January 31, 1944 (Journal - Page 5)

				Dr.		Cr.	
		Profit and Loss	30	1 260	00		
		Purchases	13			1 260	00
		To transfer cost of goods sold into Profit and Loss summary for month of January, 1944.					

The Sales and Purchases accounts are now closed, and the Profit and Loss account has a credit balance indicating the excess of sales over cost of goods sold. This is gross profit on sales, a figure upon which emphasis usually is placed in the presentation of operating statements. The computation of gross profit can be easily ascertained from the data posted to the Sales and Purchases accounts, as will be shown in preparing the statement.

The remaining nominal accounts may be closed out in the same manner; that is, by recording a separate entry to transfer each item to Profit and Loss. Time is saved, however, if only two entries are used.

January 31, 1944 (Journal - Page 5)

				Dr.		Cr.	
		Profit and Loss	30	241	00		
		Discounts on Sales	18			9	00
		Insurance	20			10	00
		Advertising	21			60	00
		Store Supplies	22			15	00
		Salaries	23			100	00
		General Expenses	24			22	00
		Depreciation	25			20	00
		Interest Expense	26			5	00
		To close expenses for month of January, 1944, into Profit and Loss summary.					

January 31, 1944 (Journal - Page 5)

				Dr.	Cr.
		Discounts on Purchases	19	6 00	
		Profit and Loss	30		6 00
		To close other income for January, 1944, into Profit and Loss.			

After the foregoing entries have been posted, an examination of the ledger will disclose that all nominal accounts are in balance except the Profit and Loss account which shows a credit balance of $205.00, representing net profit for the period. As this net profit is an increase of capital, it should be transferred to the proprietor's Capital account as follows:

January 31, 1944 (Journal - Page 5)

				Dr.	Cr.
		Profit and Loss	30	205 00	
		Dan Ross, Capital	12		205 00
		To close net profit for month of January, 1944, into Capital			

The effect of the closing entries upon the nominal summary account, Profit and Loss, and the Capital account is shown by the accounts which appear in the following section. Notice that whether simple or compound entries are used to transfer nominal account balances to Profit and Loss, the items are posted as though separate entries had been made for each income and expense account balance.

14. THE LEDGER AFTER CLOSING

The ledger of Dan Ross was so adjusted at January 31 that all accounts appearing therein could be classified either as real or nominal. We then closed the nominal account balances into the Capital account through the summary account, Profit and Loss, leaving the real account balances on the books. The condition of Dan Ross's ledger after posting the adjusting and closing entries, and extending the real account balances, is as follows:

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Cash (Page 1)

1944					1944				
Jan. 1	Investment	J1	1 000 00		Jan. 2	Fixtures	J1	100 00	
7	Brown on Acc't.	J1	400 00		4	Burns on Acc't.	J1	250 00	
10	Sales	J2	500 00		9	Merchandise	J2	800 00	
20	Jones on Acc't.	J2	441 00		14	Freight In	J2	10 00	
26	Sales	J3	750 00		23	Mercer Co.	J2	294 00	
					25	Insurance	J3	120 00	
					28	Advertising	J3	60 00	
					31	Clerk's Salary	J3	100 00	
					31	Gen'l Expenses	J3	22 00	
					31	Balance		1 335 00	
			3 091 00					3 091 00	
Jan. 31	Balance		1 335 00						

John Doe (Page 2)

1944 Jan. 1	Balance	J1	500 00				

Frank Brown (Page 3)

1944				1944			
Jan. 1	Balance	J1	1 000 00	Jan. 7	Cash and Note	J1	1 000 00

Notes Receivable (Page 4)

1944							
Jan. 7	Brown 30 days	J1	600 00				

Text No. 5

Inventory (Page 5)

1944 Jan.	1	Investment	J1	2	500	00	1944 Jan.	31	To Purchases	J4	2	500	00
Jan.	31		J4	2	350	00							

Furniture and Fixtures (Page 5)

1944 Jan.	1	Investment	J1		500	00	1944 Jan.	31	Balance down			600	00
	2	Showcases	J1		100	00							
Jan.	31	Balance			600	00							

Reserve for Depreciation of Furniture & Fixtures (Page 5)

							1944 Jan.	31	Depr. for Mo.	J4		5	00

Building (Page 6)

1944 Jan.	1	Investment	J1	5	000	00							

Reserve for Depreciation of Building (Page 6)

							1944 Jan.	31	Depr. for Mo.	J4		15	00

Land (Page 7)

1944 Jan.	1	Investment	J1	1	000	00	1944 Jan.	31	Balance down		1	500	00
	2	Lot purchased	J1		500	00							
Jan.	31	Balance		1	500	00							

COMPLETION OF THE ACCOUNTING PERIOD

Text No. 5

Victor Leads (Page 8)

1944				1944			
Jan. 6	Note	J1	1 250 00	Jan. 1	Balance	J1	750 00
				2	Land	J2	500 00
			1 250 00				1 250 00

City Supplies Company

				1944			
				Jan. 30			35 00

6

Sam Burns (Page 9)

1944				1944			
Jan. 4		J1	250 00	Jan. 1	Balance	J1	250 00

Notes Payable (Page 10)

				1944			
				Jan. 10	O.C. White	J1	2 000 00
					V.Leads 60d	J1	1 250 00

Mortgage Payable (Page 11)

				1944			
				Jan. 1	C. P. Co.	J1	1 000 00

Dan Ross (Page 12)

1944				1944			
Jan. 31	Balance down		7 250 00	Jan. 1	Investment	J1	7 500 00
				31	Profit & Loss	J5	205 00
				Jan. 31	Investments:		7 705 00

PUrchases (Page 13)

1944				1944			
Jan. 9	Cash purchase	J2	800 00				
14	Mercer Co.	J2	350 00	Jan. 31	Balance down	J4	1 150 00
Jan. 31	Balance		1 150 00	Jan. 31	Rets.&Allows		50 00
31	Frt.& Cartage	J4	10 00	31	Closing Inv.	J4	2 350 00
31	Opening Inv.	J4	2 500 00	31	Profit & Loss	J5	1 260 00

Text No. 5

Purchases Returns and Allowances

Date		Explanation	Ref.	Amount		Date		Explanation	Ref.	Amount	
1944						1944					
Jan.	31	To purchases	J4	50	00	Jan.	17	Mercer Co.	J2	50	00

Sales (Page 14)

Date		Explanation	Ref.	Amount		Date		Explanation	Ref.	Amount	
1944						1944					
						Jan.	10	Cash Sale	J2	500	00
							12	A. Jones	J2	500	00
Jan.	31	Balance down		1 750	00		26	Cash Sales	J3	750	00
Jan.	31	Rets.& Allow	J4	50	00	Jan	31	Balance		1 750	00
	31	Profit & loss	J5	1 700	00						

Sales Returns and Allowances

Date		Explanation	Ref.	Amount		Date		Explanation	Ref.	Amount	
1944						1944					
Jan.	16	A. Jones	J2	50	00	Jan.	31	To Sales	J4	50	00

Amos Jones (Page 15)

Date		Explanation	Ref.	Amount		Date		Explanation	Ref.	Amount	
1944						1944					
Jan.	12	Mdse. 2/10-n /30	J2	500	00	Jan.	16	Return	J2	50	00
								Acc't in full	J2	450	00

Mercer Supply Company (Page 16)

Date		Explanation	Ref.	Amount		Date		Explanation	Ref.	Amount	
1944						1944					
Jan.	17	Allowance	J2	50	00	Jan.	14	Mdse.2/10-n/30	J2	350	00
	23	Acc't.in full	J2	300	00						

Freight and Cartage In (Page 17)

Date		Explanation	Ref.	Amount		Date		Explanation	Ref.	Amount	
1944						1944					
Jan.	14	Cash	J2	10	00	Jan.	31	To Purchases	J4	10	00

Discount on Sales (Page 18)

Date		Explanation	Ref.	Amount		Date		Explanation	Ref.	Amount	
1944						1944					
Jan.	20	A. Jones	J2	9	00	Jan.	31	Profit & Loss	J5	9	00

Discounts on Purchases (Page 19)

1944				1944			
Jan. 31	Profit & Loss	J5	6 00	Jan. 23	Mercer Co.	J2	6 00

Insurance (Page 20)

1944				1944			
Jan. 25	Ppd. for year	J3	120 00	Jan. 31	Ppd. 11 mos.	J4	110 00
					Profit & Loss		10 00

Advertising (Page 21)

1944				1944			
Jan. 28	Cash, Daily News	J3	60 00	Jan. 31	Profit & Loss	J5	60 00

Store Supplies (Page 22)

1944				1944			
Jan. 30	City Supplies	J3	25 00	Jan. 31	Supplies Inv.	J4	10 00
					Profit & Loss	J5	15 00

Salaries (Page 23)

1944				1944			
Jan. 31	Clerk for month	J3	100 00	Jan. 31	Profit & Loss	J5	100 00

General Expenses (Page 24)

1944				1944			
Jan. 31	Tel., Light, etc.	J3	22 00	Jan. 31	Profit & Loss	J5	22 00

Depreciation (Page 25)

1944				1944			
Jan. 31	Furn. & Fixt.	J4	5 00	Jan. 31	Profit & Loss	J5	20 00
	Building	J4	15 00				

Interest Expense ~~Depreciation~~ (Page 26)

1944				1944			
Jan. 31	Accrued Mtge.	J4	5 00	Jan. 31	Profit & Loss	J5	5 00

Accrued Interest Payable (Page 27)

				1944			
				Jan. 31	On mortgage	J4	5 00

Text No. 5

Prepaid Insurance (Page 28)

1944 Jan.	31	To 12/31/44	J4	110	00				

Store Supplies Inventory (Page 29)

1944 Jan.	31	On Hand	J4	10	00				

Profit and Loss (Page 30)

1944 Jan.	31	Purchases (cost of goods sold)	J5	1,260	00	1944 Jan.	31	Sales, net	J5	1,700	00
	31	Discounts on Sales	J5	9	00		31	Discounts on Purchases	J5	6	00
		Insurance	J5	10	00						
		Advertising	J5	60	00						
		Supplies used	J5	15	00						
		Salaries	J5	100	00						
		Gen'l Expenses	J5	22	00						
		Depreciation	J5	20	00						
		Interest Exp.	J5	5	00						
	31	Ross, Capital	J5	205	00						
				1,706	00					1,706	00

15. POST-CLOSING TRIAL BALANCE:

After the books have been closed, some bookeepers consider it advisable to take another trial balance for the purpose of checking the accuracy of the books and furnishing a basis for the preparation of one of the major financial statements--the balance sheet. A trial balance such as this, taken immediately after closing, is known as a post-closing trial balance, and contains only real account balances, with valuation accounts as follows:

Dan Ross
Post-Closing Trial Balance
January 31, 1944

Cash	$1,335	
John Doe	500	
Notes Receivable	600	
Inventory	2,350	
Furniture and Fixtures	600	
Reserve for Depr. of Furniture & Fixtures		$ 5
Building	5,000	
Reserve for Depreciation of Building		15
Land	1,500	
City Supplies Company		25

Text No. 5

Dan Ross
Post-Closing Trial Balance (Cont.)

Notes Payable		$ 3,250
Mortgage Payable		1,000
Dan Ross, Capital		7,705
Accrued Interest Payable		5
Prepaid Insurance	$ 110	
Store Supplies Inventory	10	
	$ 12,005	$12,005

16. THE BALANCE SHEET

Periodically the owners of a business call upon the accountant or bookkeeper to furnish a statement showing total assets, liabilities and capital. Such a statement taken from a double entry set of books is called a Balance Sheet. The balance sheet is an important financial statement not only because it is the basis of the entire accounting structure but also because it affords invaluable information to anyone who is interested in the affairs of the business. A balance sheet prepared in accordance with approved methods of accounting gives an accurate presentation of the financial condition of a business at a given date.

An examination of the ledger of Dan Ross at January 31 reveals that all the real accounts are open and that all the expense and income accounts are closed. The balance sheet is based upon the open accounts. If the accountant wishes to prepare a balance sheet, he may gather all the required data from the ledger and merely transcribe the balances of the asset, liability, and capital accounts to a standard balance sheet form. However, since a post-closing trial balance has been prepared, it will not be necessary to refer back to the ledger. A balance sheet may be prepared by rearranging in proper form the items set forth on the post-closing trial balance. This rearrangement consists of setting up all customers' accounts on the balance sheet under the heading of Accounts Receivable and all creditors' accounts under the heading of Accounts Payable; indicating the valuation reserves on the debit side as a deduction from the assets to which they are related, arranging the items according to asset, liability, or capital rather than merely debit or credit.

There are two forms in which balance sheet accounts may be set up-- the account form and the report form. In the account form, assets appear upon the left-hand side, liabilities and capital upon the right-hand side. The following is an illustration of the balance sheet arranged in account form:

Text No. 5

Dan Ross
Balance Sheet January 31, 1944

Assets			Liabilities		
Cash		$ 1,335	Accounts Payable		$ 25
Accounts Receivable		500	Notes Payable		3,250
Notes Receivable		600	Accrued Interest Payable		5
Merchandise Inventory		2,350	Mortgage Payable		1,000
Furniture & Fixtures	$600				
Less: Reserve for			Net Worth		
Depreciation	5	595	Dan Ross, Capital	$7,500	
Building	5,000		Net Profit for Month	205	7,705
Less: Reserve for					
Depreciation	15	4,985			
Land		1,500			
Prepaid Insurance		110			
Store Supplies Inventory		10			
Total Assets		$11,985	Total Liabilities and Net Worth		$11,985

The report form lists the assets first, followed by liabilities and capital. One form seems to be about as common as the other. The report form, however, is easier to prepare on the typewriter. Below are the same items rearranged for the purpose of illustrating the report form of balance sheet:

Dan Ross
Balance Sheet January 31, 1944

Assets

Cash		$ 1,335.00
Accounts Receivable		500.00
Notes Receivable		600.00
Merchandise Inventory		2,350.00
Furniture and Fixtures	$ 600.00	
Less: Reserve for Depreciation	5.00	595.00
Building	5,000.00	
Less: Reserve for Depreciation	15.00	4,985.00
Land		1,500.00
Prepaid Insurance		110.00
Office Supplies Inventory		10.00
Total Assets		$11,985.00

Liabilities

Accounts Payable		$ 25.00
Notes Payable		3,250.00
Accrued Interest Payable		5.00
Mortgage Payable		1,000.00

Net Worth

Dan Ross, Capital	$7,500.00	
Net Profit for Month	205.00	7,705.00
Total Liabilities and Net Worth		$11,985.00

In the arrangement of items under the heading of Assets, we have chosen to start with Cash and list the various assets in order of their realization, while liabilities are shown in the probable order of their liquidation.

17. THE PROFIT AND LOSS STATEMENT

At the close of an accounting period, the owners and management of a business want to know the results of operations. It is true that this could be ascertained by comparing the amounts of net worth as disclosed by the opening and closing balance sheets after taking into consideration any withdrawals or contributions of capital. Merely to know that a gain has been realized or a loss sustained, however, is not sufficient. The management needs to know why a net profit or net loss has occurred. Since the income and expense accounts show the causes for profit or loss (change in capital from operations), another report must be provided to outline and explain these causes. The report that serves this purpose is known as a profit and loss statement. This statement may be given other titles, such as a statement of earnings and expenses, statement of revenue and expenses, income statement, statement of operations, etc.

Since the income and expenses are summarized in the Profit and Loss ledger account, these data may be said to constitute the basis for the profit and loss statement. Therefore, in order to prepare a profit and loss statement, it is only necessary to make a transcript of the Profit and Loss Account in the ledger. If the items are similarly arranged, that is, expenses on the left and income on the right, the statement is known as an account form, or technical form, of profit and loss statement. Inasmuch as the report form is more easily prepared on the typewriter, it is important to master this form of profit and loss statement.

In the report form of profit and loss statement for a merchandising concern, there are ordinarily three sections: (1) the "Trading" section showing sales, cost of goods sold, and gross profit; (2) the "Operating Expense" section showing the costs of selling goods and managing the business; and (3) the

"Other Income and Expense" section showing financial and other items of income and expense.

The following is a report form profit and loss statement prepared from the data found in the Profit and Loss account of Dan Ross and the Sales and Purchases accounts for detailed information as to trading:

Dan Ross

Profit and Loss Statement

For the month of January 1944

Sales			$1,750.00
Less: Returns and Allowances			50.00
Net Sales			$1,700.00
Cost of Goods Sold:			
Merchandise Inventory Jan. 1		$2,500.00	
Purchases	$1,150.00		
Less: Returns & Allowances	50.00	1,100.00	
Freight and Cartage in		10.00	
Goods Available for Sale		3,610.00	
Merchandise Inventory Jan. 31		2,350.00	1,260.00
Gross Profit on Sales			$ 440.00
Operating Expenses:			
Insurance		10.00	
Advertising		60.00	
Supplies used		15.00	
Salaries		100.00	
Depreciation		20.00	
General Expenses		22.00	227.00
Net Operating Profit			$ 213.00
Other Income:			
Discounts on Purchases		6.00	
Other Expenses:			
Discounts on Sales	9.00		
Interest Expense	5.00	14.00	8.00
Net Profit for the Month			$ 205.00

18. STATEMENT FORMS

The foregoing statements have been drawn up in order to point out certain fundamental principles rather than to stress construction of the forms. The forms in which statements are prepared present many variations depending upon the size and character of the business, and no practical purpose would be served by attempting at present to study the accounting technique pertaining to more involved statements. It may be advisable, however, to call attention to the manner in which the two basic statements are headed. The heading of each statement contains (1) the name of the concern and (2) the title of the statement. The profit and loss statement then shows the period during which the profits were earned, while the balance sheet gives merely the closing

date; that is, the profit and loss statement covers business operations over a period of time, while the balance sheet intends to show the financial condition of the business at a specified date.

A more detailed discussion of statement forms, content, and preparation will be given in a subsequent text.

19. SUMMARY

The steps in adjusting and closing the books and preparing statements may be summarized as follows:

1. Take a pre-closing trial balance to test the accuracy of the ledger.
2. Adjust the pre-closing trial balance by making entries for:
   (a) Merchandise inventories
   (b) Estimated depreciation
   (c) Bad debts
   (d) Deferred charges to expense
   (e) Deferred credits to income
   (f) Accrued assets and income
   (g) Expenses and accrued liabilities
3. Prepare an adjusted trial balance after posting adjusting entries.
4. Debit income accounts and credit Profit and Loss to transfer income. Debit Profit and Loss and credit expense accounts to transfer expenses.
5. Close Profit and Loss Account balance into the Capital account, unless a personal account has been set up to show withdrawals and additional investments of capital. In this event net profit or loss would be closed to the personal account and the personal account balance then closed into Capital.
6. Prepare a post-closing trial balance.
7. Prepare a balance-sheet from the post-closing trial balance, the actual ledger accounts remaining open, or from the adjusted trial balance.
8. Prepare the profit and loss statement either from the Profit and Loss ledger account or from the adjusted trial balance. Refer to Sales and Purchases accounts for details of merchandise trading.

The illustrative accounts of Dan Ross were closed as of January 31 and will not be carried any further since they have served the purpose for which they were intended. The important features of this or any double entry set of accounts extending over a definite period of time are:

(1) The opening balance sheet, used as a basis for the initial journal entry;
(2) The journalizing and posting of all transactions;
(3) Adjusting and closing the accounts at the end of the period;
(4) Preparation of the profit and loss statement and the closing balance sheet.

COMPLETION OF THE ACCOUNTING PERIOD

Text No. 5

As the balance sheet marks the terminus of an accounting period, it has been aptly referred to as the origin and purpose of all accounting. In the further study of accounting, therefore, the effect of each journal entry upon the balance sheet should always be kept clearly in mind. It has been illustrated that although the balance sheet is altered by each business transaction the relationship of its elements is constant and can always be expressed by the fundamental equation Assets - Liabilities plus Capital.